United States Senate
WASHINGTON, DC 20510

January 1, 2013

The Honorable Gene L. Dodaro
Comptroller General of the United States
Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Comptroller General Dodaro:

There is broad bipartisan support for the position that we must end "too big to fail" (TBTF) government policies, whereby the U.S. government provides financial support to large financial institutions to protect them from failures of their own making. The largest Wall Street megabanks enjoy protection from a "safety net" – a variety of explicit and implicit guarantees that their profits will be enjoyed by private parties and the costs will be paid by taxpayers.[1] Wall Street megabanks, their shareholders, and their bondholders expect the U.S. government to step in during a crisis and provide capital to keep them in business. The implicit – and in some cases explicit – taxpayer-funded safety net provides subsidies to these large financial institutions.

Though Congress has enacted financial sector reforms that its supporters, both in Congress and the Administration, intended to mitigate the TBTF problem, we are concerned that these measures may not be sufficient to eliminate government support for the largest bank holding companies. Federal Reserve Board Governor Daniel Tarullo recently lamented, "to the extent that a growing systemic footprint increases perceptions of at least some residual too-big-to-fail quality in such a firm, notwithstanding the panoply of measures in Dodd-Frank and our regulations, there may be funding advantages for the firm, which reinforces the impulse to grow."[2]

We therefore request that GAO conduct a study of the economic benefits that bank holding companies (BHCs) with more than $500 billion in consolidated assets receive as a result of actual or perceived government support. Specifically, we ask that you study:

1. *The favorable pricing of the debt of these bank holding companies, relative to their risk profile resulting from the perception that such institutions will receive Government support in the event of any financial stress;*

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[1] *See*, *e.g.*, Remarks By Paul A. Volcker Before The Statutory Congress Of The European People's Parties, Bonn, Germany, Dec. 9, 2009 ("One consistent response has been to protect and support national commercial banking systems with a combination of regulation and a so-called 'safety net', including deposit insurance and a central bank able and willing to serve as a 'lender of last resort'. The central idea is to provide liquidity to troubled but solvent institutions while protecting individual depositors.").
[2] *See* Remarks by Daniel K. Tarullo, At the Distinguished Jurist Lecture, University of Pennsylvania Law School, Philadelphia, Pennsylvania, October 10, 2012.

In short, the largest banks are able to borrow more cheaply than they otherwise would, based upon their risk profiles.[3] According to the Federal Reserve Bank of Dallas, "TBTF banks' sheer size and their presumed guarantee of government help in time of crisis have provided a significant edge—perhaps a percentage point or more—in the cost of raising funds."[4]

The IMF estimates that banks larger than $100 billion have about a 50 basis points (bps) funding advantage over banks in the $10-100 billion range.[5] The *Wall Street Journal* editorial board noted that, in 2010, "[t]he funding advantage enjoyed by banks with more than $100 billion in assets over those in the $10-$100 billion range rose from 71 basis points in the first quarter to 78 basis points in the third quarter ... The advantage increased to 81 in the fourth quarter."[6]

There have already been significant studies of the effects that explicit and implicit government guarantees have on institutions' ability to borrow in the capital markets. Several academic studies have sought to calculate the precise borrowing advantages enjoyed by the largest banks, ranging from 10 to 88 bps and providing billions of dollars in economic benefits.[7]

2. *Any favorable funding or economic treatment resulting from an increase in the credit rating for these BHCs, as a result of express, implied, or perceived Government support;*

Credit rating agencies have stated that they will consider the likelihood of government support when determining an institution's credit rating.[8] Government support provides five of the six

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[3] *See* Anat R. Admati, Peter M. DeMarzo, Martin F. Hellwig & Paul Pfleiderer, *Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Expensive*, Stanford University Working Paper No. 86 (Mar. 2011) at 22.

[4] Rosenblum, *supra*, at 17.

[5] *See* İnci Ötker-Robe, Aditya Narain, Anna Ilyina, & Jay Surti, *The Too-Important-to-Fail Conundrum: Impossible to Ignore and Difficult to Resolve*, IMF SDN/11/12, May 27, 2011 at 6, Figure 1.

[6] Review & Outlook, *Still Too Big, Still Can't Fail*, WALL ST. J. (Mar. 5, 2011).

[7] *See* Andrew G. Haldane, Executive Director, Financial Stability, Bank of England, "The $100 Billion Question", Comments at the Institute of Regulation & Risk, Hong Kong, Mar. 30, 2010 at 5; *see also* International Monetary Fund, *A Fair And Substantial Contribution By The Financial Sector: Final Report For The G-20*, June 2010, at 55-56 (estimating that government support provides "too big to fail" institutions with a funding benefit between 10 and 50 bps, with an average of about 20 bps); *see also* Santiago Carbo-Valverde, Edward J. Kane & Francisco Rodriguez-Fernandez, *Safety-Net Benefits Conferred On Difficult-To-Fail-And-Unwind Banks In The US And EU Before And During The Great Recession*, Paolo Baffi Centre Research Paper Series No. 2011-95, at 9-10 (finding that "too big to fail" banks receive a safety net subsidy between 10 and 22 bps per dollar of assets, and also show more leverage); *see also* A. Joseph Warburton & Deniz Anginer, "The End of Market Discipline? Investor Expectations of Implicit State Guarantees" 4 (Nov. 18, 2011) (finding that large banks had an annual funding cost advantage of approximately 16 bps before the financial crisis, increasing to 88 bps during the crisis, and peaking at more than 100 bps in 2008. The authors estimate the total value of the implicit government subsidy at about $4 billion per year before the financial crisis, $60 billion during the crisis, and a high of $84 billion in 2008) *available at* http://ssrn.com/abstract=1961656; *see also* Dean Baker & Travis MacArthur, *The Value of the "Too Big to Fail" Big Bank Subsidy*, Center for Economic and Policy Research (2009) (estimating that, at the time of the financial crisis, banks with assets in excess of $100 billion had an average borrowing advantage of 78 bps, implying a subsidy of $34.1 billion a year).

[8] *See* Standard & Poor's, *The U.S. Government Says Support For Banks Will Be Different "Next Time"—But Will It?*, 9-10 (July, 2011)("Ultimately, in our views of new legislation and regulation, we need to consider the long track-record of extraordinary support that may be essential for a handful of institutions despite government reluctance to offer such support.").

largest banks with a boost in their credit ratings of one to three notches.[9] Though this perceived support is lower than it had been before the financial crisis, it clearly still exists.[10]

Some estimate that implicit governmental guarantees provide a subsidy of 3.10 percent per year to the cost of equity capital for the largest banks, and impose a 3.25 percent tax on the smallest banks, amounting to an annual subsidy of $4.71 billion per bank.[11] By doubling the size of its market capitalization, a bank receives a subsidy of 68 bps.[12]

The credit rating bump resulting from government support may not just allow TBTF megabanks to borrow at lower rates. This boost may also results in more favorable terms for their financial contracts, including posting less margin behind their derivatives contracts.

3. *Any economic benefit to these BHCs resulting from the ownership of, or affiliation with, an insured depository institution;*

Support, such as FDIC deposit insurance, provides insured depository institution affiliates of bank holding companies with government support, both real and perceived. Markets believe that, despite existing deposit insurance caps, all deposits of the largest backs are ultimately protected.[13]

Government support also provides insured depository institutions with higher credit ratings that can encourage institutions to shift activities into these subsidiaries. For example, Bank of America moved $15 trillion in derivatives contracts from its broker-dealer, Merrill Lynch, to its insured depository institution affiliate in response to a credit downgrade. The result is that taxpayers would subsidize, and ultimately backstop, potentially risky investments. This move reportedly saved the bank $3.3 billion in additional collateral payments.[14]

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[9] *See* Susanne Craig & Peter Eavis, *Three Major Banks Prepare for Possible Credit Downgrades*, N.Y. TIMES DEALBOOK, Mar. 29, 2012, *available at* http://dealbook.nytimes.com/2012/03/29/three-major-banks-prepare-for-possible-credit-downgrades.

[10] *See* Esther L. George, President and Chief Executive Officer, Federal Reserve Bank of Kansas City, "Looking Ahead: Financial Stability and Microprudential Supervision" 6, Levy Economics Institute of Bard College, 21st Annual Hyman P. Minsky Conference, New York, N.Y., Apr. 11, 2012 ("These ratings advantages continue to exist after the crisis—albeit at a notch or two less now, and investors have reason to believe that similar advantages may yet exist.").

[11] *See* Priyank Gandhi & Hanno Lustig, *Size Anomalies in U.S. Bank Stock Returns: A Fiscal Explanation*, NBER Working Paper 16553 (2010) at 5.

[12] *See id.*, at 26 ("[A] 100% increase in the size of market cap relative to GDP ... increases the subsidy by 68 bps per annum.").

[13] *See* Nathaniel Popper & Jessica Silver-Greenberg, *Big Depositors Seek a New Safety Net*, N.Y. TIMES, Dec. 31, 2012 at BU1 ("For the nation's largest banks, there is a widely shared assumption that the government would be forced to provide a backstop to protect depositors in a crisis, as it did in 2008. 'Implicitly or explicitly, most of this money is going to still be guaranteed,' said Bruce Hinkle, an executive with Farin & Associates, a consulting firm that works with banks."); *see also id.* ("The vast majority of the holdings in these accounts are above the $250,000 limit and are held in the nation's largest banks. That money is expected to stay put no matter what, in part because corporations and municipalities widely believe that the government will step in if those large banks encounter trouble, effectively considering them too big to fail.").

[14] *See* Bob Ivry, Hugh Son & Christine Harper, *BofA Said to Split Regulators Over Moving Merrill Derivatives to Bank Unit*, BLOOMBERG, Oct. 18, 2011 *available at:* http://www.bloomberg.com/news/2011-10-18/bofa-said-to-split-regulators-over-moving-merrill-derivatives-to-bank-unit.html. Moody reportedly considered cutting Bank of

When the Federal Reserve granted a 23A exemption to Goldman Sachs Bank in 2009, Goldman moved its multi-purpose derivatives dealer into its insured bank affiliate. Likewise, Morgan Stanley converted to a bank holding company, and received a 23A exemption for its derivatives business. And JPMorgan Chase Bank, N.A., currently holds 99 percent of the notional derivatives of JPMorgan Chase & Co.[15]

Morgan Stanley is reportedly considering similar measures in response to a threatened downgrade by Moody's.[16] Such a downgrade could require Morgan Stanley to post as much as $6.5 billion over the course of a year.[17]

4. *Any economic benefit resulting from the status of these BHCs as a bank holding company, including access to the discount window of the Board of Governors of the Federal Reserve System; and*

The sweep of the government safety net was expanded during the financial crisis of 2008, when Goldman Sachs and Morgan Stanley converted to bank holding companies, in large part to participate in Federal Reserve programs, including the Federal Reserve's discount window.[18] This development was, "widely interpreted as a clear signal that the federal government would not let either of them fail."[19]

The Federal Reserve also made a series of decisions to exempt insured banks from Section 23A of the Federal Reserve Act, and extend the safety net of bank holding companies to repurchase agreements, or "repos," and derivative dealing activities.[20] Professor Saule Omarova has argued that, "the Board dismantled the entire section 23A regime in order to make an emergency transfusion of the federal subsidy into the shadow banking system."[21]

5. *Any economic benefit to these BHCs received through extraordinary Government actions taken during the financial crisis, including actions taken to prop up the government-sponsored enterprises and the insurer American Insurance Group (AIG).*

The benefits of the safety net were on display during the financial crisis, with the largest megabanks receiving a disproportionate amount of assistance. One IMF report found that an institution's size plays a key role in authorities' decisions about whether the bank receives a bailout in the event of distress.[22] It should therefore come as no surprise that 190 financial firms

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America's rating further, potentially requiring up to $4.5 billion in additional cash and collateral. *See* Craig & Eavis, *supra.*

[15] *See* Office of the Comptroller of the Currency, OCC's Quarterly Report on Bank Trading and Derivatives Activities Second Quarter 2011, at Table 1, Table 2.

[16] *See* Tracy Alloway, *Morgan Stanley Tries to Stave off Ratings Cut*, FINANCIAL TIMES, Apr. 5, 2012, *available at* http://www.ft.com/intl/cms/s/0/99979138-7e67-11e1-b20a-00144feab49a.html#axzz1rAjV9Gao.

[17] *See* Craig & Eavis, *supra.*

[18] *See* Saule T. Omarova, *From Gramm-Leach-Bliley To Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act*, 89 N.C. L. REV. 1683, 1745-46 (2011).

[19] *Id.*, at 1746.

[20] *See id.*, at 1735-41; *see also id.*, at 1745-50.

[21] *Id.*, at 1690.

[22] *See* Ötker-Robe, Narain, Ilyina, & Surti, *supra*, at 8.

borrowed $1.2 trillion from the Federal Reserve from 2007 to 2009,[23] with the six biggest U.S. banks borrowing as much as $460 billion and accounting for 63 percent of the average daily debt to the Fed.[24] The same six firms also received $160 billion in Troubled Asset Relief Program (TARP) funds.[25] According to the Congressional Oversight Panel for TARP (COP), the six largest banks received a total of $1.27 trillion in government support.[26]

Commentators have noted that a loan to an underwater bank is a long-shot investment whose substantial downside easily justifies a 15% to 20% return, comparable to the rates charged on risky sovereign bonds.[27] But the Fed's emergency lending was not nearly so stringent – for example, the Federal Reserve's Term Auction Facility maxed out at an interest rate of 4.67 percent.[28] The result is that failing banks can borrow money far more cheaply than the market would bear. Comparing net interest margins for these loans and the loans made by banks, *Bloomberg* estimates that the six largest banks made $4.8 billion in profit from these loans–equal to 23 percent of their combined net income during those two years.[29]

Some suggest that other central bank policies provide significant subsidies to struggling banks well after the financial crisis.[30] For example, a recent paper by the Federal Reserve Bank of New York found that, despite extraordinary purchases of mortgage-backed securities, there is currently a 115 bps spread between primary and secondary mortgage rates.[31] The paper estimates that mortgage loan rates are 70 bps higher than they should be based upon secondary market prices, and conclude that this results in profits for mortgage lenders.[32]

TARP also provided megabanks with significant benefits. The COP concluded that "Treasury paid substantially more for the assets it purchased under the TARP than their then-current market value."[33] This provided the six biggest megabanks with a subsidy of $25 billion.[34]

The largest banks also benefit from the bailouts of Fannie Mae and Freddie Mac, which will cost taxpayers the most of any action taken during the financial crisis. The two companies have received nearly $187 billion in taxpayer assistance and their conservator projects that the two

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[23] *See* Bob Ivry, Bradley Keoun & Phil Kuntz, *Secret Fed Loans Gave Banks Undisclosed $13B*, BLOOMBERG, Nov. 27, 2011 available at http://www.bloomberg.com/news/2011-11-28/secret-fed-loans-undisclosed-to-congress-gave-banks-13-billion-in-income.html.
[24] *See id.*
[25] *See id.*
[26] *See* Congressional Oversight Panel, *March Oversight Report: The Final Report of the Congressional Oversight Panel* 36 (Mar. 2011).
[27] *See* Kane, *supra*, at 6.
[28] *See* Board of Governors of the Federal Reserve, Term Auction Facility Data, available at http://www.federalreserve.gov/newsevents/files/taf.xls.
[29] *See* Ivry, Keoun & Kuntz *supra.*
[30] *See* Yalman Onaran, ZOMBIE BANKS: HOW BROKEN BANKS AND DEBTOR NATIONS ARE CRIPPLING THE GLOBAL ECONOMY 67 (Bloomberg Press, 2012).
[31] *See* Andreas Fuster & David Lucca, "Why Isn't the Thirty-Year Fixed-Rate Mortgage at 2.6 Percent?", Liberty Street Economics, Dec. 31, 2012 available at http://libertystreeteconomics.newyorkfed.org/2012/12/why-isnt-the-thirty-year-fixed-rate-mortgage-at-26-percent-.html.
[32] *See id.*
[33] *See* Congressional Oversight Panel, *supra*, at 39.
[34] *See id.*

companies will require $191 billion to $209 billion by the end of 2015.[35] The two companies' market share for the first half of 2012 spiked to 77 percent meaning that that, when combined with Ginnie Mae who securitizes government-backed loans, the taxpayer is guaranteeing 100 percent of the mortgages originated.[36]

These are just some examples of the issues that we hope that you will examine in your study. Thank you for your prompt attention to this request, and we look forward to working with you as you move forward on this important study. Please contact Graham Steele on Senator Brown's staff at (202) 224-3215 or Travis Johnson on Senator Vitter's staff at (202) 224-4623 if you have any questions.

Sincerely,

Sherrod Brown
Chairman
Financial Institutions and
Consumer Protection Subcommittee
Committee on Banking, Housing,
and Urban Affairs

David Vitter
Ranking Member
Economic Policy Subcommittee
Committee on Banking, Housing,
and Urban Affairs

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[35] *See* Federal Housing Finance Agency, Projections of the Enterprises' Financial Performance, Oct. 2012.

[36] *See* Federal Housing Finance Agency, Conservator's Report on Enterprises' Financial Performance, Second Quarter 2012.